Room151

LGPS INVESTMENT ROUNDTABLE

Income, inflation & farmland investment

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SPONSORED ROUNDTABLE

LGPS funds are increasing their allocations to real assets, the hunt for income and inflation hedging is well underway and diversification from traditional asset classes is in demand. Does investing in agriculture tick all these boxes?

Room151

ROOM151 EVENTS & SPONSORED CONTENT

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AT THE TABLE

Jason Fletcher
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Merseyside Pension Fund (Northern Pool)

Julian Pendock
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Luke Webster
CIO
Greater London Authority

Iain Campbell
Investments Manager
Greater Manchester Pension Fund

Karen Shackleton
Senior Adviser
Allenbridge & Independent Adviser

Detlef Schoen
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Chris Bourchier
Independent Director of Global Farmland
Insight

Sherilee Mace
Director, Business Development
Insight Investment

Peter Findlay
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Room151.

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SPONSORED ROUNDTABLE

Income, inflation & farmland investment

Peter Findlay:
Detlef, please kick us off with some background about farmland investing.

Detlef Schoen
Over the last ten years I think we've got away from the sort of hype which coincided with the global financial crisis (GFC) when we were talking about Malthusian scarcity scenarios. Today, largely driven by technology, we're back to a situation where supply and demand are pretty much in balance and it's no longer that generic tail wind that is driving interest in agriculture.

One has to keep at the back of one's mind that there are two sectors in the world that are intrinsically cash flow positive—if you're a least-cost producer: energy and food.

Now, with energy there's a lot of least-cost production happening, some with unappetising technologies, or in risky geographies, but we are lucky in agriculture in the sense that a lot of stable, developed—or at least investment grade economies—are least-cost producers for food commodities.

At Insight we ask: "Where are the least-cost producers, how can we narrow those down to certain geographies and sectors where we feel comfortable?"

Detlef Schoen, Insight Investment

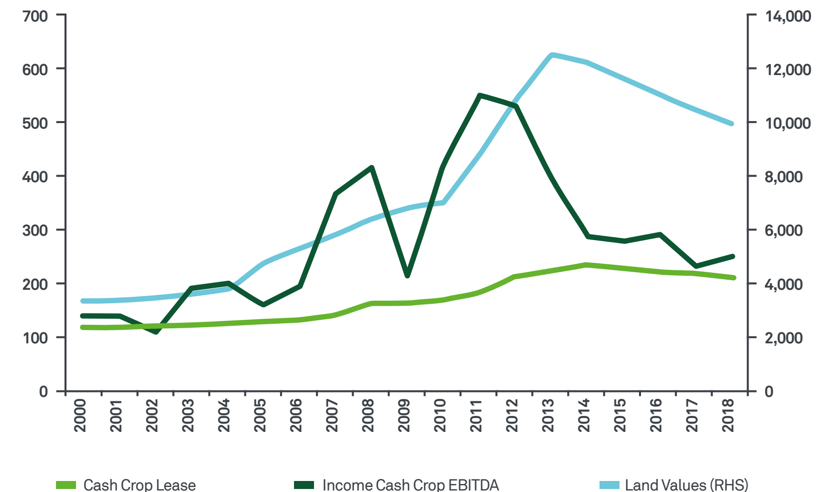
Why should anybody invest in agriculture beyond the income component? There are two main reasons: one is the lack of correlation between agriculture and bonds and equities which has been well-documented over time; and, equally well-documented, is the very strong correlation between agriculture and inflation.

Over time people began to look at agriculture, or farmland investments, as an alternative to owning gold, if you will, where gold is costing you money to store and farmland is giving you a return if you store it.

The attention is shifting away from the more private equity, closed-end universe that we saw during the hype of 2008-11, and back to a core, long-term, thematic approach to agriculture.

We have price volatility that everyone knows about. However in agriculture—

Cash Crop EBITDA, lease income and land values



- Two investment models to access the asset class have been used:
  - the 'pure beta play' (dominant in the USA) of investing passively by leasing to farmers, predicated on the tenant generating a sustainable and adequate margin of EBITDA over lease rate
  - the active-management, 'value-add' approach capturing the full EBITDA returns
- Equally, two allocation strategies have been pursued:
  - the geographically focused approach
  - the geographically diversified approach

- As the diagram demonstrates for US row crops, farm ROA as such and the spread of farm ROA over lease rate have reverted to long-term mean metrics and below – thus putting pressure on land prices, decreasing the comfort margin for the passive investor and favouring the owner-operator model
- From the outset Insight has pursued a globally diversified and actively managed corporate farming model
- This means that today Insight Farmland has a significant competitive advantage which it is aiming to apply for the benefit of its investors

unless you are a truly dominant supplier in which case yield losses go hand in hand with price increases—that can be compounded by yield volatility. We have climate change, we have all sorts of impact on yields and volumes and sometimes, unfortunately, they can go in the same direction, so you have to prepare yourself if you have invested in agriculture. In the long term there is a need for positive cash flows to ensure that vital foodstuffs continue to be produced and there is an inflation hedge, but on a short-term basis you will always see a reasonably wide fluctuation in returns.

I think the real attraction for agriculture in today's environment given what's going on in the institutional landscape such as low interest rates and cap rates, is the long-term nature of it. Agriculture lends itself to evergreen structures; it lends itself to the pursuit of sustainable development goals (SDG). Agriculture empirically needs to be sustainable otherwise at some stage obviously you don't have anything to farm anymore. So, it is much more natural, if that's the right word, for an agricultural strategy to pursue SDGs than some more generic manufacturing business, for example.

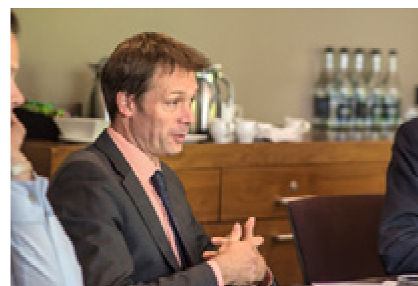
One last issue: the more you rely on an owner/operator model, the more you need people that have been there and done it and have a strong combination of institutional professionalism on the one hand, and boots on the ground experience, on the other. Don't underestimate the value of having been there and driven a combine, farmed the land or milked the cows.

"I think a lot of money has been roped into passive strategies. Today the sponsors of those strategies are scratching their heads and reconfiguring their approach."
Detlef Schoen
Insight Investment

Peter Findlay
A lack of correlation with bonds and equities and correlation to inflation—are these attractive for you, Jason?

Jason Fletcher
I inherited an agriculture investment at West Midlands and the reason they invested is clearly for all those things: so, not being correlated with the other assets that we've got and the long term returns that we're expecting. I think there is an inflation correlation over the long term but you can have long periods where that doesn't work, which is something we need to consider.

But why do we invest in agriculture? It's because we're trying to meet our liabilities in the pension fund and I think it has some of those attributes—the most important one being that it's not correlated to equities in particular. I think in terms of pension fund issues about investing in it as an asset class, it's not very easy to invest in and it's jolly expensive.



Jason Fletcher, Central Pool

Peter Findlay
What's difficult about investing in it?

Jason Fletcher
There are not an awful lot of options in terms of how you can do it; there aren't many listed vehicles. You can use futures as a way of getting liquid exposure to agriculture, which is cheaper, but actually buying farmland is expensive. Whether you do it directly or through a fund, one of the drawbacks of the investment is the cost. Overall, I do think agriculture and related areas are a good place for pension funds to invest and it fits very much with our trying to get a risk-adjusted return, after costs, which is the key thing we need.

Julian Pendock, London CIV

Julian Pendock
I think it comes down to why would you buy a real asset? And, as we're starting at the London CIV with more of a clean sheet of paper given our lack of direct investments in real assets, for various reasons we look at the basics: do you want capital gains, total return, cash flow, so on and so forth?

And what I've seen, as shown by Insight here, is that agriculture has become professionalised. All the large funds are in it so a lot of the easy gains have gone, like other real assets. A lot of it's being driven by total return, increase in the price of land, compression of yield—all the same drivers which have affected a lot of our other asset classes, so that's had a dent in the lack of correlation.

Going forward, yes, technology is amazing, when you look at farms in the mid-west with GPS-fitted combine harvesters that drive themselves and farmers that can see market pricing online while they're working.

So long term, yes, it's good that it's more efficient but obviously I would argue that the easy gains have gone. But I think agriculture does warrant a place in real asset allocations. It's interesting to see what has happened to Harvard [endowment fund], who were in the FT yesterday. They sort of went overboard, and, to be cynical for a moment, when the big institutions all sell out of something it could be time to have another look. So, yes, we would certainly have a look for all the reasons discussed but we're not piling in.

Peter Findlay
Detlef, the easy gains have gone and there are some long periods where the correlation to inflation doesn't necessarily work?

Detlef Schoen
It very much reconfirms what I said earlier. I think this hype, post-GFC, made it seem as if agriculture was something that a backseat driver could generate very significant returns from and, if you tailored your statistics accordingly, you could demonstrate that over a certain period of time owning farmland in the US would beat any index under the sun.

And using that argument, I think that a lot of money has been roped into passive strategies. Today the sponsors of those strategies are scratching their heads and reconfiguring their approach.

What one must also say, and we have to accept this at Insight as well, is that there's been a lot of over-promising going on and if you look at what good, top-quartile farmers generate in the developed economies in today's interest rate climate—adjusted for inflation—I think a four percent cash yield is pretty much the benchmark with an eight percent IRR, i.e., a four percent capital appreciation driven by yield increases and technological advances.

Peter Findlay
Does that four to eight percent bracket sound appealing to investors in the current environment?

Peter Wallach, Merseyside Pension Fund (Northern Pool)

Peter Wallach
Clearly it does. I think we've had limited experience [of agriculture]. We have invested in a US farmland fund and perhaps the barbell approach: a fund investing in the Ukraine. I think that probably the challenge for farmland, or agriculture, has been the availability of returns elsewhere.

As pension funds we're looking at the whole array of asset classes and the whole array of real assets and there have been very attractive returns for example from renewable energy, providing some of those less-correlated income producing opportunities. As those go away, things like agriculture will become of more interest.

Certainly we have a stated ambition of increasing our allocation to infrastructure. That's a slightly narrow definition and perhaps real assets is a better one than infrastructure. Potentially agriculture would fit within that frame.

Peter Findlay
Karen, when you're talking to LGPS clients about this fund or other agricultural funds, typically where are you talking about it sitting within their portfolio?

"The great thing about this fund is that committees understand it."
Karen Shackleton
Independent Adviser

Karen Shackleton
We talk about various places: as a diversifying asset, as an income generator and also the inflation linking discussed earlier. Personally, I think inflation is the key one—the long-term thematic, inflation protection is where I would be most likely to cover agriculture with clients. And I think inflation is going to become a bigger problem for us over the coming years than it has been in recent years.

The great thing about this fund is that committees understand it. It's a tangible asset and members will understand what you're talking about and I think a lot of the products competing in the four to eight percent secure income brackets involve quite complicated underlying transactions. I'm somebody who really likes it if I'm confident that the people that I'm advising really understand what they're getting in to.

Karen Shackleton, Allenbridge & Independent Adviser

Luke Webster
From a pension fund management point of view, I like cash generative assets and the best way to take market risk off the table is by not having to sell stuff. If you can generate money to pay your pensions, that's great, and I think the yields available from agriculture are very attractive in absolute terms.

The inflation protection—which is enormously attractive in the long term—does require a certain diversification to achieve on a shorter-term basis. If you're relying on the income to pay pensions, having a single agriculture asset drives up the risk that the inflation linkage is lost in the general yield volatility.

So, the fund structure is very much appropriate, depending on the scale of the investment. There's a very interesting dimension here with pooling as we get up to scale. There becomes more opportunity to co-invest with experienced partners, such as Insight potentially, or directly own assets.

If you're a small scale investor looking at it, your position has to be extremely long term for it to be a sensible asset allocation. If you have direct ownership, as in any direct position, it comes down to backing the right team.

Iain Campbell
We have agricultural investment and it forms part of our long-core special opportunities portfolio which includes some very different, uncorrelated assets – a key driver of returns for us. Cash flow is becoming an increasing problem for pensions and with so little income available from bonds currently we are always interested in sources of yield.

I can understand the inflation linkage that's been discussed over the long term, but obviously pension fund liabilities are linked to a specific measure of inflation, UK CPI, which is based on a basket of goods, not just food.

A challenge pension funds always have is familiarity. We're all familiar with property: you can buy a property, rent it out, you understand it, you know what you're doing. People feel well-versed in traditional asset classes like equities and bonds, and understand the terminology that surrounds those but UK pension funds are arguably less well-versed when it comes to farmland.

What returns are likely to come from it? What are your risk exposures going to be? What can potentially cause you problems? And what makes a good manager? You might believe you understand what a good equity management can do but do you know how to pick a good farmland manager? Perhaps now, given the pooling situation, administering authorities can decide whether or not they like agriculture as an asset class and leave the due diligence to their colleagues at the pools.

Peter Findlay
Detlef, what does a good farmland manager do?

Detlef Schoen
Well, a good manager is that rare beast who is a farmer who learned finance rather than a reconfigured investment banker who read up about farming.

It goes back to the inherent risks in farming: price volatility, yield volatility, political risk, weather risk, there are all sorts of risks. Farming looks sort of very romantic on the surface but it's a system which has unfortunately more variables than equations. There's always a degree of risk and the best way to deal with it is simply experience. I've been farming for 35 years now and I think that's crucial.

There's nothing more dangerous than a 25 year-old fund manager getting into farming.

There are a lot of good, local practitioners in agriculture and you need a network of them to be a good farmland fund manager. We can't possibly do everything ourselves but if I can pick up the phone to a local manager in this part of Australia or that part of Brazil or the Great Plains to ask for a quick thumbs up or down about an opportunity, that is extremely valuable.

COUNTRY RATING FRAMEWORK & RESULTS

Grains	Weightage - High				Weightage - Medium			Composite score
Countries/ Region	Political framework	Economic status	Tax & regulatory	Direct cost	Talent pool	Ancilliary service	Headroom to grow	
Argentina	Red	Red	Red	Teal	Teal	Light green	Teal	Red
Australia	Teal	Teal	Teal	Teal	Teal	Teal	Teal	Teal
Angola	Red	Red	Red	Red	Red	Red	Red	Red
Brazil	Red	Yellow	Red	Teal	Teal	Light green	Teal	Light green
Belize	Red	Red	Red	Red	Red	Red	Red	Red
Canada	Red	Teal	Yellow	Teal	Teal	Teal	Teal	Red
Colombia	Yellow	Yellow	Yellow	Red	Red	Yellow	Teal	Yellow
China	Red	Teal	Yellow	Teal	Yellow	Yellow	Yellow	Red
Eastern Europe	Yellow	Yellow	Yellow	Teal	Yellow	Yellow	Teal	Light green
Great Britain	Yellow	Light green	Teal	Teal	Teal	Teal	Teal	Teal
India	Red	Teal	Yellow	Red	Teal	Teal	Teal	Red
Mexico	Red	Yellow	Red	Light green	Yellow	Yellow	Light green	Orange
Nigeria	Red	Red	Yellow	Red	Yellow	Orange	Teal	Red
New Zealand	Light green	Teal	Teal	Teal	Teal	Teal	Light green	Teal
Pakistan	Red	Red	Red	Red	Orange	Orange	Red	Red
Spain	Light green	Teal	Teal	Light green	Teal	Teal	Light green	Light green
USA	Teal	Teal	Light green	Teal	Teal	Teal	Teal	Teal
Uruguay	Teal	Light green	Light green	Light green	Light green	Orange	Yellow	Light green

SCALE FOR COMPOSITE SCORE

Color	Notation
Teal	Preferred choice
Light green	Can consider with lower allocation
Yellow	Potential 2nd stage
Orange	Revisit at later date for assessment
Red	Avoid

SCALE FOR RATING

Color	Notation
Teal	Top quartile
Light green	Mixed as cost benefit may not extend
Yellow	Head room to improve
Orange	Challenging unless signifigant change
Red	Avoid

Sherilee Mace
It's difficult to express in hard numbers, but where we can show added value to clients, for example, is in the value of an asset at the point when a good manager takes it on compared to that asset's value at some point in the future. ESG plays an important part of any investment we make, and I would argue that ESG is the foundation of farmland. If you get that right, everything else should follow on from there.

Peter Findlay
And Sherilee, what are your reflections on what you've heard from the different funds so far?

Sherilee Mace
Clearly, one of the key messages I'm hearing is that income generation is increasingly important to people, whether you get that from agriculture, property or some other source. I also think investors would like to see more of an evergreen structure rather than a closed-end fund and we're looking at that type of approach at Insight.

> *"ESG plays an important part of any investment we make, and I would argue that ESG is the foundation of farmland."*
> **Sherilee Mace**

Peter Findlay
Chris, timing must be important in agriculture and we're at a critical point in time vis-a-vis Brexit. How is that going to impact agriculture?

Chris Bourchier
Someone once said to me that anyone can extrapolate a trend but it's identifying the points of inflection that matter and we are at such a point in agriculture. We're moving from a traditional industry that has been protected and managed through various mechanisms, such as the CAP. Now those are being removed. Farm businesses are becoming far more professional and far more competitive—and that's happening worldwide.

This transformation is going to accelerate in the UK as a result of Brexit. You don't tend to see the effects of change for some time. The locals know who's farming land by whose tractors are on it. You don't get a declaration in the mail—but you are getting gazelle businesses, super businesses growing and influencing agriculture hugely and these are the guys who have access to capital. They can bring in new technology and have the support to understand what that technology can deliver. That's quite a change from the past where the pace of change was slower, being influenced by local factors.

It is an industry in change. I do think that there'll be tremendous opportunities, with winners in Brexit terms, but there are inevitably going to be losers and we think we've got a view of where the biggest risks lie.

Peter Findlay
A view you can share with us today?

Chris Bourchier
At present it seems to be a day-by-day discussion at the political level, but if Brexit becomes quite hard then there will be free market operations with less direct support where the strong thrive and the weak really do suffer, unless they're supported by the "new" politics.

It's not the very small, resilient family businesses who are the most vulnerable, it's the next level who have borrowed and are in the process of expansion that are at greatest risk. The big guys will be okay, although they may lose some asset value in the short term.

If you're asking, "which sectors are vulnerable?" you only have to look at some of the research reports that have been produced recently highlighting the sheep sector is hugely vulnerable.

Julian Pendock
I'm really fascinated by what happened in New Zealand, all those years ago, when they got unshackled from a structure, a bit like the CAP. Do you think that on a smaller scale we might be in for an ultimately painful, but long overdue optimisation of the industry?

Sherilee Mace, Insight Investment

Chris Bourchier
I suppose I've been around politics long enough to know it won't be quite as crisp and clean as that.

But the direction of travel I would agree with. New Zealand had an imperative and they had to do it. The UK can afford to make it less extreme than that, but equally there would be a rapid rate of change to justify the sorts of support that the UK tax payer is prepared to continue to put into farming.

Peter Findlay
A question for the funds. Is the share of allocations to real assets growing?

Peter Wallach
Yes, very definitely. We have eight percent in property, seven percent in infrastructure and that will only grow, and we have some modest investments in real-type-assets, elsewhere in the fund. So, yes, we're moving in that direction.

Peter Findlay
To what sort of level?

Peter Wallach
I would say a third of the portfolio wouldn't be unduly challenging.

Jason Fletcher
From my side, real assets will rise as a proportion of assets and that's driven by the fact that we have maturing funds and there is an increasing need for yield going forward.

At the moment government bonds are nowhere near covering our liabilities and if we can find something that gives us downside protection, and income, then that's going to be attractive.

Julian Pendock
I think we're all reluctant bulls because there simply aren't many alternatives, no pun intended. One thing that concerns me is that many of us are long-only beta refugees. We're trying to get away from overall market pricing. But by definition, if you have a pool of capital that thinks it's getting out of long-only beta and goes into something else, by definition that then becomes correlated with beta.

People need to understand that the lack of correlation probably won't match today's expectations but overall, yes, the appetite for real assets is absolutely picking up pace.

"There is potentially a wall of capital flowing towards real assets, so getting good results comes down to resources."
Luke Webster, GLA

Luke Webster
In a pension fund context it's clearly an appropriate part of the portfolio. To echo Julian's point, there is potentially a wall of capital flowing towards real assets, so getting good results comes down to resources. Operating in this asset space is much more resource intensive so identification of good strategic partners clearly helps.

Iain Campbell
Greater Manchester is building out the real assets portfolio as well through property and through infrastructure with our GLIL fund. It's seen as a diversifier away from traditional assets and potentially offering enhanced yield. I would agree, we need to be careful about it because of the liquidity considerations and because there's been a lot of money moving towards alternative assets.

Luke Webster, Greater London Authority

"One thing that concerns me is that many of us are long-only beta refugees."
Julian Pendock
London CIV

Karen Shackleton
I'm certainly seeing clients allocating to infrastructure, we've got a couple looking at that at the moment. I think in terms of how much funds are likely to allocate to real assets, that is related to how well-funded they are. Those that have still got quite a lot of ground to cover are always going to be focussed more on the growth assets than on the inflation protecting and income generative assets, and it will depend on their cash flow needs as well, which again is a variable thing.

With the smaller clients, ease of access is an important consideration and this will be an advantage of pooling. If [administering authorities] can just say, "oh well, let's go for our pool's sub-fund", then that's a lot simpler when you may not have the governance resources yourself to do appropriate due diligence on a fund.

Jason Fletcher
All investors want income going forward for the reasons already discussed. I just want to raise a bit of caution: there are some key things that are holding us back and the first of those is cost. Cost is something that is going to come far more into focus—what is the genuine real cost [of an investment]? So, the discussion of an eight percent IRR, for example, is that net or gross?

Iain Campbell, Greater Manchester Pension Fund

Detlef Schoen
That's net.

Jason Fletcher
Given there aren't a lot of available assets in the UK, whereas our liabilities are in Sterling, then we are going to be taking on some currency risk, which is fine in mature markets where you can hedge currency. The problem is when all the exciting land you want to invest in is in Cambodia, or Brazil, for example, and currency hedging in those areas isn't quite so easy.

The other issue is the illiquidity premium and we've got to prove that it's there. There are liquid versions available for agri-investors so we have to go back to the value. When we choose between a liquid and an illiquid asset to access a given strategy it has to come down to value. While it looks likely we are all going to put more money into these areas, there are provisos we need to overcome.

Detlef Schoen
I couldn't agree more. In terms of the currency hedging, our strategy is to invest in more mature markets where we see least-cost production and that makes currency hedging viable.

In terms of the liquidity issue, I've taken a lot of comfort from today's discussion as what we're planning is to a) go evergreen but b) open regular liquidity windows, which is predicated on an increased appetite for the space. We're exploring a structure around bi-annual liquidity after a five-year initial lock-up period.

To the point about where does agriculture fit into your portfolio, we have maybe seven or eight investors round the table and probably five different pockets where the money may be allocated. So you have infrastructure, you have real assets, you have alternatives etc., and you can make a good case for all of them. I'm happy with all of that as long as it's not private equity. Once it's private equity it needs to go to direct, bespoke investments with clearly defined land-use change, for example, or other transformation opportunities.

Chris Bourchier, Insight Investment

Peter Findlay
Chris, a final thought from you ...

Chris Bourchier
From my point of view, when you're looking at agriculture, I would say if you're aiming at getting family values expressed within corporate disciplines, then you're in the sweet spot. We know what the family values can deliver: the track record and the resilience is fantastic. We know that corporate discipline (with capital) is needed to transform the sector, but if you can put the two together then you really are in the right place to make progress, whatever the world throws at you.

"If you're aiming at getting family values expressed within corporate disciplines, then you're in the sweet spot."
Chris Bourchier

COUNTRY CROP COMPETITIVENESS FRAMEWORK USING COST BASIS

Product segment	Style	Conventional/ Organic	UK	Australia	New Zealand	Eastern Europe	Central & Latin America	North America
Arable crops	Active	Conventional		fibre	grain	grain	rics	grain
Arable crops	Active	Organic	grain	fibre	grain	grain		fibre/ grain
Livestock	Active	Conventional		grass fed		grain	grass fed	grain fed
Dairy	Active	Conventional	grass fed	grass fed	grass fed	grain		grain fed
Dairy	Active	Organic		grass fed				grain fed
Fresh vegetables	Active / Passive	Conventional						
Fresh vegetables	Active / Passive	Organic						
Permanent crops	Active/ Passive	Conventional	apple	almonds, avocado	avocado, apple		avocado	almonds, pistachio
Permanent crops	Active/ Passive	Organic	apple	almonds, avocado	avocado, apple		avocado	almonds, pistachio

SCALE FOR DIRECT COST COMPETITIVENESS

Color	Notation
	Leader on a truly commercial basis
	Potential to be in top quartile
	Not suitable
	Unproven scale

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LGPS INVESTMENT ROUNDTABLE

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